United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-4277

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

SCHUSTER'S EXPRESS, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

B

P/S

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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STATEMENT OF THE ISSUES PRESENTED

Taxpayer is a motor freight common carrier, which is a self-insurer as to cargo losses and the loss-deductible portion of its insured collision losses. Its collision insurance premiums were subject to retrospective adjustments based on loss experience. Taxpayer uses the accrual method of accounting. Prior to 1968, it was taxpayer's practice to estimate its insurance expenses and uninsured losses, and taxpayer created a reserve account for such items. Taxpayer claimed a current deduction for additions to the reserve. In 1968, the Commissioner of Internal Revenue required taxpayer to terminate this practice for federal tax purposes, and to use only actual expenditures as the basis for

for deductions. Taxpayer acceded to this change, but there remained a substantial balance in the reserve account as of the beginning of 1968. The Commissioner of Internal Revenue sought to require the taxpayer to include this balance (representing prior deductions) in income for 1968 under Section 481 of the Code. In this context, the questions are:

1. Whether the taxpayer's change, as required by the Commissioner, from the use of estimates to the use of actual expenditures in accounting for insurance costs and for uninsured loss and damage claims was a change in method of accounting.

2. Whether the balance in the taxpayer's reserve for insurance expense at the beginning of the year when it changed to actual expense deductions was includible in its taxable income for that year as an adjustment necessary solely by reason of the change in order to prevent this balance from being omitted from income.

STATEMENT OF THE CASE

This is an appeal by the Commissioner of Internal Revenue from a decision by the United States Tax Court (Judge Goffe) refusing to include in the taxable income of Schuster's Express, Inc. (taxpayer) for the taxable year ended June 30, 1968, a balance of $73,020 which stood in a reserve for insurance expense maintained by the taxpayer at the beginning of that year. (R. 1-2, 87, 90-91, 95-96.)[1/] The findings of fact and opinion of the Tax Court, which were filed on June 24, 1976,

1/ "R." references are to the separately bound record appendix.

are reported at 66 T.C. 588. (R. 94-114.) The decision of the Tax Court was entered, pursuant to a Rule 155 computation, on September 9, 1976. (R. 115.) The Commissioner filed a timely notice of appeal on December 7, 1976. (R. 2.) The jurisdiction of this Court is invoked under Section 7482 of the Internal Revenue Code of 1954.

The facts, as found by the Tax Court and as shown by the record are as follows:

During the taxable year ended June 30, 1968, the taxpayer was a common carrier engaged in an interstate trucking business, with its principal place of business in Colchester, Connecticut. (R. 83-84, 96; Stip. Ex. 2-B.) At all relevant times, the taxpayer maintained its books and filed its federal income tax returns on an accrual method of accounting with a fiscal year ending June 30th. (R. 83-84, 85-86.) During the fiscal years ended June 30, 1966, and June 30, 1967, the taxpayer maintained an account entitled "Reserve for Insurance." (R. 85-86.) Each month during the year ended June 30, 1966, the taxpayer deducted from its income a total of five percent of its revenues for insurance expense. (R. 85, 86-87.) This five percent charge was intended to cover the premiums payable on various insurance policies covering the risks inherent in the taxpayer's business, as well as to cover any expenditures with respect to risks for which the taxpayer acted as a self-insurer. (R. 84-86.) The taxpayer's program of self-insurance primarily covered claims for lost or damaged freight, and collision damage losses to the

taxpayer's trucks which were within the loss deductible portion of its collision coverage. (R. 84-85.) Actual expenditures for these items were charged as insurance expenses on the taxpayer's books, and each month an adjusting entry was made to bring the total of such charges to five percent of the taxpayer's revenues, with a corresponding credit or debit to the "Reserve for Insurance" account. (R. 86-87.) The total charges for insurance expenses during the year ended June 30, 1966, exceeded the taxpayer's actual expenses for such items by $69,980. (R. 86-87.) This amount was deducted on the taxpayer's federal income tax return for the fiscal year ended June 30, 1966. (R. 86-87.)

In the fiscal year ended June 30, 1967, the taxpayer reduced its provision for insurance expense to 4.5 percent of its revenues, and continued its practice of adjusting its actual insurance expenditures at the end of each month to match its estimates. (R. 87.) The total insurance expense charges thus deducted during the year exceeded its expenditures for these items by $3,040. (R. 87.) This excess of deductions over expenditures in fiscal 1967 was reflected in an increase of $3,040 in the balance in the "Reserve for Insurance" account, which, accordingly, stood at $73,020 on June 30, 1967. (R. 87.)

In fiscal 1968 the taxpayer continued its practice of adjusting its insurance expense deductions each month to match its estimates based on 4.5 percent of its revenues. (R. 88.) At the end of the year, however, the taxpayer reduced its insurance expense deduction by $34,545 and reduced the reserve for insurance

by a like amount in order to bring the reserve down to what the taxpayer considered to be an appropriate amount after reviewing the claims for lost or damaged freight outstanding against it at the end of the year. (R. 88.) The reserve, as thus adjusted, totaled $99,138 at June 30, 1968. (R. 88.)

The Commissioner disallowed the taxpayer's insurance expense deductions in 1968 to the extent of the $99,138 closing balance in the reserve. (Pet. Ex. A, pp. 2-3.) The taxpayer admitted that the Commissioner had correctly disallowed $26,118 of this balance, since this amount represented the excess of the insurance expense deductions claimed by the taxpayer in fiscal 1968, after taking into account the year-end adjustment described above, over the taxpayer's actual expenditures in that year. (R. 12-13, 88-89, 102.) The taxpayer contended, however, that correction of the errors made in fiscal years 1966 and 1967 which gave rise to the reserve balance of $73,020 on June 30, 1967, was barred by the statute of limitations. (R. 12-13, 87, 102.) At trial, the Commissioner contended that under Section 481 of the Code, the taxpayer was required to include the balance of $73,020 in its income for fiscal 1968 in order to prevent this balance from being deducted twice solely by reason of its change of method of accounting from the use of estimates to the use of actual expenditures.[2/] (R. 20-21.)

2/ At the outset of the trial, the parties raised the issue whether the Commissioner's failure to refer to Section 481 of the Code in his statutory notice of deficiency or in his answer to the petition shifted the burden of proof with respect to the applicability of that section to the Commissioner under Rule 39 of the Rules of Practice and Procedure of the United States Tax Court (Jan. 1, 1974). (R. 14-17, 24, 32.) Before any evidence

The Tax Court held that Section 481 was not applicable to the item here in dispute. In the first place, the Tax Court held that the taxpayer's change from the use of estimates to the use of actual expenditures in deducting its insurance expenses was not a change of method of accounting because its prior practice was simply wrong and resulted in erroneous and excessive deductions which failed to reflect the taxpayer's total lifetime income. (R. 107-112.) The court was also of the view that even if the change in question were a change in method of accounting, the amount here in dispute did not arise solely because of the change, since in the absence of a change, there was no assurance that the taxpayer would ever have been required to recognize additional income by reason of the excessive deductions in earlier years. (R. 113-114.) The Tax Court accordingly refused to apply Section 481 to require the adjustment sought by the Commissioner, and from this adverse decision the Commissioner brings this appeal.

2/ (continued):
was presented, the Tax Court ruled that the statutory notice of deficiency was not sufficient to inform the taxpayer that the Commissioner intended to apply Section 481, and, therefore, the burden of proof with respect to the applicability of that section was shifted to him. (R. 39, 41.) In its opinion, the Tax Court found that, although the issue had not been raised in the pleadings, the taxpayer had been given sufficient advance notice that the Commissioner intended to rely on Section 481 to enable it to prepare adequately for trial. (R. 104.) Accordingly, the court held that the Commissioner was entitled to rely on Section 481 in support of his determination. (R. 104.) The court reaffirmed its ruling made at trial, however, that the burden of proof with respect to this issue rested with the Commissioner. (R. 109.)

SUMMARY OF ARGUMENT

I. The Tax Court erred in rejecting the Commissioner's contention that the taxpayer changed its method of accounting in its fiscal year ended June 30, 1968, when it was required by the Commissioner to change from the use of a reserve for insurance expense to the use of actual expenditures in computing its tax deductions for insurance and uninsured loss and damage claims. Under its old method of accounting, the taxpayer had deducted estimates which exceeded its actual expenses by a total of $73,020, an amount which was carried in a reserve for insurance account at the beginning of its 1968 fiscal year. In concluding that the taxpayer had simply claimed excessive and unallowable deductions in the years prior to 1968, the Tax Court failed to recognize that the taxpayer had, in fact, made two separate mistakes in computing its deductions for insurance expenses in those years. The first, and fundamental, error was that the taxpayer deducted an addition to a reserve which was not expressly authorized by statute. This error involved an impermissible method of accounting, which the taxpayer was required to change in 1968. The second error was that the taxpayer misapplied its reserve method of accounting by deducting excessive and unrealistic amounts as additions to the reserve. It was this error, which did not involve a separate method of accounting, which caused the distortion of the taxpayer's income in the prior years.

The change from the deduction of an addition to a reserve to the deduction of actual expenditures was clearly a change in the timing of a deduction. Under generally accepted financial accounting principles,

a reporting company is required to deduct from its current income any forseeable expenses which can be reasonably estimated and can be properly allocated to the current accounting period. On the other hand, under the principles of annual tax accounting, an expense does not become deductible until all events have occurred which fix the taxpayer's liability to pay it. Where, as here, the all events test of tax accounting results in delaying a deduction, which may have been accruable under generally accepted accounting principles in an earlier year when the related revenues were earned, to a later year when the expense was ascertained and paid, the resulting change is clearly a change in the timing of a deduction. Accordingly, under the applicable Treasury Regulations, the taxpayer is required to treat the change in question as a change in method of accounting.

II. The taxpayer's change from the deduction of an addition to a reserve for insurance expense to the deduction of actual expenditures in fiscal year 1968 left the previously deducted $73,020 opening balance in the reserve with no function under the taxpayer's new method of accounting. Implicit in the taxpayer's reserve method of accounting was the assumption that actual expenses for insurance premiums and loss and damage claims not covered by insurance would be charged to the reserve and would not result in any deductions from income when paid. As a result of the change in accounting method, and solely as a result of that change, no further charges would ever be made to the reserve in fiscal 1968 and later years, and the taxpayer's actual expenses became deductible from its income when paid. It is precisely this kind of doubling

up of deductions which Section 481 was intended to prevent. Accordingly, the Tax Court should have allowed the Commissioner to include the $73,020 opening balance in the reserve in the taxpayer's taxable income for its fiscal year 1968.

ARGUMENT

I

THE TAXPAYER'S CHANGE FROM THE USE OF ESTIMATES TO THE USE OF ACTUAL EXPENDITURES IN ACCOUNTING FOR INSURANCE COSTS AND FOR UNINSURED LOSS AND DAMAGE CLAIMS WAS A CHANGE IN METHOD OF ACCOUNTING WITHIN THE MEANING OF SECTION 481 OF THE INTERNAL REVENUE CODE OF 1954

Section 481(a) of the Internal Revenue Code of 1954, Appendix, *infra*, provides:

> (a) *General Rule*.--In computing the taxpayer's taxable income for any taxable year * * *--
>
> (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
>
> (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted* * *.

In addition to making any adjustments required under this section, a taxpayer who desires to change his method of accounting normally must also obtain the Commissioner's consent to the change, as required by Section 446(e) of the Code, Appendix, *infra*, before he computes his taxable income under the new method of accounting. The provisions of Sections 446 and 481 evidently were intended to be read in pari materia, and the Regulations reflect this close relationship between the two sections. Treasury Regulations

on Income Tax (1954 Code), Section 1.481-1(a)(1), Appendix, infra, defines the changes to which Section 481 applies by reference to the rules under Section 446, specifically to Treasury Regulations on Income Tax (1954 Code), Section 1.446-1(e), Appendix, infra. Subparagraph 2(ii) (a), Appendix, infra, of that paragraph states:

> * * * A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. * * * A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. (Emphasis added.)

This language was added to the Regulations by T.D. 7073, 1970-2 Cum. Bull. 98, as part of a revision designed to clarify the meaning of the statutory reference to changes in method of accounting, and to provide examples distinguishing between changes in method of accounting and changes in accounting treatment resulting from changes in the underlying facts of the transactions. Compare Section 1.446-1 (e)(2) as originally promulgated by T.D. 6282, 1958-1 Cum. Bull. 215, 220-221 with the revised language of that section in T.D. 7073, supra.

The Tax Court held (R. 106-112) that the taxpayer's change from the use of estimates to the use of actual expenditures in computing its expenses for insurance and for uninsured loss and damage claims was not a change in method of accounting, but rather that it represented the disallowance of improper and excessive deductions--deductions which were not properly accruable in any year. In thus rejecting the Commissioner's contention that the change in question was a change in method of accounting, the Tax Court relied primarily on Holt Co., Inc. v. United States, 368 F. 2d 311 (C.A. 5, 1966), aff'g 65-2 U.S.T.C., par. 9464

(W.D. Tex., April 5, 1965). In that case, the District Court found as a fact that the taxpayer, a manufacturer and distributor of sporting goods, had, at all material times, employed the specific charge-off method of accounting for bad debts, as opposed to the reserve method. 65-2 U.S.T.C., p. 96,062. During the years in question the taxpayer in Holt had charged off, under its method of accounting, certain so-called "Country Accounts Receivable" which were not in fact worthless when charged off, later reporting recoveries on such accounts as income when received. The court of appeals affirmed the judgment of the District Court in refusing to treat such erroneous charge-offs as a method of accounting, pointing out that such a practice "is nothing more than a method of distorting income in favor of the taxpayer." 368 F. 2d., p. 312.

Holt, supra, provides no support for the refusal of the Tax Court in the present case to find that the change by the taxpayer here from the use of estimates to the use of actual expenditures was a change in method of accounting. In the first place, in Holt, unlike here, the trial court found that the taxpayer was at all times using a method of accounting (specific charge-off) which required a case by case determination of the worthlessness of each account receivable before it could be charged off. Thus the taxpayer's mistake in Holt appears to have been the erroneous application of that method of accounting to the facts of each individual transaction. Here, on the other hand, the taxpayer changed from a method of accounting under which an estimate based on a percentage of gross revenues was deducted from income each

year without regard to the amounts actually paid out (R. 85-86), to the use of a completely different principle, namely that expenditures could be deducted only as incurred (R. 102). Moreover, the decisions of both the District Court and the court of appeals in Holt were rendered before the change in the language of the Treasury Regulations amplifying and clarifying the meaning of the phrase "change in method of accounting." T.D. 7073, *supra*. It is not clear from the opinions in the Holt case whether the taxpayer there in fact made an individual determination of worthlessness with respect to each of the charged-off Country Accounts Receivable, as required under its accounting method (see, Treasury Regulations on Income Tax (1954 Code), § 1.166-1(a), and § 1.166-2(a) (26 C.F.R.)), or whether the taxpayer misapplied its accounting method by systematically charging off its Country Accounts Receivable when they met some pre-established standard of worthlessness, such as failure of the account debtor to pay within a certain number of days after payment was due. Thus, the Holt case has little, if any, precedential value under the new Regulations; if the Commissioner disallowed the deductions in question because he disagreed with the taxpayer's finding of worthlessness with respect to specific accounts, the resulting change would not be a change in method of accounting under Treasury Regulations on Income Tax (1954 Code), Section 1.446-1(e)(2)(ii)(b), Appendix, *infra*. On the other hand, if he disallowed the deductions because he disagreed with the taxpayer's supposed practice of systematically charging off accounts which were not worthless

and then including recoveries on such accounts in income in later years, the resulting change would probably qualify as a change of accounting method under the new Regulations. See, Treasury Regulations on Income Tax (1954 Code), § 1.446-1(e)(2)(iii), Examples 6 and 7 (26 C.F.R.).

The Tax Court concluded (R. 109-110) that the taxpayer's change from the use of estimates to the use of actual expenditures was not a change in method of accounting because the taxpayer's prior practice of deducting estimated expenses did not properly reflect its total lifetime income. See, Treasury Regulations on Income Tax (1954 Code), § 1.446-1(e)(2)(ii)(b). In reaching this conclusion, the Tax Court failed to recognize that, in the absence of an express statutory authorization for deducting an addition to a reserve, the reserve method of accounting is not allowable for income tax purposes regardless of whether the amount of the addition to the reserve which the taxpayer seeks to deduct would have been considered reasonable for financial statement purposes. With the single exception of a reserve for bad debts, which has been authorized by Section 166(c) of the Code (26 U.S.C.), the addition to a reserve for estimated expenses has long been held unallowable for income tax purposes because "the events necessary to create the liability do not occur during the taxable year." Brown v. Helvering, 291 U.S. 193,

200 (1934).[3] Accord, United States v. Anderson, 269 U.S. 422, 424 (1926).

Having failed to appreciate the fact that the taxpayer's use of an addition to a reserve for insurance expenses was not allowable for income tax purposes, whether or not the amounts deducted were excessive, the Tax Court was misled by the fact

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3/ The legislative history of the accounting provisions of the Internal Revenue Code of 1954 shows that the reason why specific authority is necessary to deduct an addition to any type of reserve is that an open ended allowance of such deductions would produce unacceptable revenue losses. The Internal Revenue Code of 1954, as enacted on August 16, 1954, contained two accounting provisions, enacted as Sections 452 and 462 (26 U.S.C. 1952 ed., Supp. II §§ 452 and 462), one of which permitted the postponement of recognition of prepaid income (Sec. 452), and the other of which permitted the deduction of additions to reserves for estimated expenses (Sec. 462). These two sections were retroactively repealed by the Act of June 15, 1955, c. 143, 69 Stat. 134, Sec. 1. In the House Report accompanying this repeal bill, the Committee on Ways and Means acknowledged that Sections 452 and 462 had been enacted in an effort to bring tax accounting principles more nearly into line with generally accepted accounting principles with respect to the timing of income and the incurring of expenses. H. Rep. No. 293, 84th Cong., 1st Sess., p. 3 (1955-2 Cum. Bull. 852, 853-854). However, after the provisions were enacted, the Treasury Department increased its estimate of the revenue loss resulting from the transition from $47,000,000 to over $1,000,000,000 and accordingly the Committee acquiesced in the Treasury Department's request for repeal of these sections, pending further studies of the best means of achieving conformity between generally accepted accounting principles and tax accounting rules. H. Rep. No. 293, supra, pp. 3-4 (1955-2 Cum. Bull., p. 853-855). The Senate Finance Committee also recommended passage of the repeal bill, noting that this repeal represented a step away from the goal of conformity, but pointing out that, because of the unanticipated revenue loss, further legislative action would be required to write definite rules into the income tax law before such conformity could be achieved. S. Rep. No. 372, 84th Cong., 1st Sess., pp. 3-6 (1955-2 Cum. Bull. 858, 859-861).

that the taxpayer here had consistently overestimated its insurance expense deductions under the reserve method which it purported to use. (R. 86-88.) It was this misapplication of the reserve method, not the use of the method itself, which gave rise to the erroneous and excessive deductions which the Tax Court found to have distorted the taxpayer's lifetime income. (R. 109-110.) In short, the Tax Court failed to recognize that the taxpayer here made two separate errors in the tax treatment of its insurance expense account. The first and fundamental error was in the use of an impermissible method of accounting -- namely, the computation of its insurance expenses by accruing and deducting periodic additions to a reserve for future liabilities. The second error, which did not involve a separate method of accounting, was that the taxpayer misapplied its reserve method of accounting by deducting excessive and unreasonable estimates of its future liabilities, thereby distorting its income.

The distinction between the financial accounting definition of an accruable liability and the legal definition of a deductible expense for federal tax purposes is clearly a question of timing. Under generally accepted accounting principles, a reporting company is required --

> to provide, by charges in the current income statement, properly classified, for all for-seeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

American Institute of Certified Public Accountants, <u>Accounting Research Bulletin No. 43</u> (Accounting Research and Terminology

Bulletins (Final ed., 1961)), Chapter 6, par. 4, pp. 41-42. The purpose of the financial accounting requirement is to assure the matching of current expenses against current revenues in accordance with the basic principles of accrual accounting. Finney and Miller, Principles of Accounting -- Intermediate (6th ed., 1965), pp. 10, 381-384. Under the principles of annual federal tax accounting, however, an expense which is merely forseeable does not thereby become deductible. Brown v. Helvering, supra, p. 200; Milwaukee & Suburban Transport Corp. v. Commissioner, 18 T.C.M. 1039, 1049-1051 (1959), rev'd on this issue, 283 F. 2d 279, 283-288 (C.A. 7, 1960), rev'd and remanded, 367 U.S. 906 (1961), decision of the Tax Court aff'd on remand, 293 F. 2d 628 (C.A. 7, 1961), cert. denied, 368 U.S. 976 (1962); World Airways, Inc. v. Commissioner, 62 T.C. 786, 800 (1974), appeal pending (C.A. 9 - No. 75-2176). See United States v. Consolidated Edison Co., 366 U.S. 380 (1961); American Automobile Assn. v. United States, 367 U.S. 687 (1961). Rather, the taxpayer must wait until all events establishing its legal liability to pay have become fixed before claiming any deduction. Brown v. Helvering, supra, p. 200; United States v. Consolidated Edison Co. supra, p. 385. Where, as here, the "all events" test of tax accounting results in delaying the deduction of an item which may be properly accruable for financial statement purposes in an earlier year when the corresponding income is earned, to a later year when the legal liability becomes fixed, such a delay clearly

involves the proper time for taking a deduction. Accordingly, the taxpayer's change from an erroneous use of a reserve for estimated liabilities to an acceptable method of treatment of such liabilities was a change in its method of accounting within the meaning of Treasury Regulations on Income Tax (1954 Code), Section 1.446-1(e), supra.

II

THE INCLUSION OF THE $73,020 OPENING BALANCE IN THE TAXPAYER'S RESERVE FOR INSURANCE ACCOUNT IN ITS TAXABLE INCOME FOR THE FISCAL YEAR ENDED JUNE 30, 1968, WAS REQUIRED SOLELY BY REASON OF ITS CHANGE OF METHOD OF ACCOUNTING

Having concluded that the taxpayer's use of estimates in computing its insurance expenses resulted in erroneous and excessive deductions, the Tax Court went on to hold that, even if such a use of estimates constituted a method of accounting, the elimination of the balance in the reserve account was not an adjustment required solely by reason of the taxpayer's change in method of accounting and hence the taxpayer could not be required to make such an adjustment under Section 481 of the Internal Revenue Code of 1954. (R. 112-114.) The court sought to justify this conclusion by pointing out that even if the change had not been made, under the taxpayer's reserve method it would not necessarily have been required to account for its previous excessive deductions in later years. (R. 113.) This explanation ignores the fact that even where the deduction of an addition to a reserve is authorized, as under Section 166(c) in the case of a reserve for bad debts, the taxpayer is not at liberty to deduct any amount he pleases.

Indeed, the Regulations under Section 166 specifically require that a taxpayer who uses the reserve method of deducting bad debt losses must take into account the excess or inadequacy of its prior estimates in computing the amount of reasonable addition to the reserve for the current year. Treasury Regulations on Income Tax (1954 Code), § 1.166-4(b)(2) (26 C.F.R.), _supra_. A fortiori, where, as here, the use of the reserve method was not authorized in the first place, there is no justification for permitting the taxpayer to ignore the tax consequences of its prior erroneous application of that method, thereby avoiding taxation altogether on the balance in the reserve. As the court stated in _Witte_ v. _Commissioner_, 513 F. 2d 391, 394 (C.A.D.C.,1975), a case involving the consent requirement of Section 446:

> The purpose of the consent requirement is to enable the Commissioner to prevent distortions of income that often accompany changes in accounting methods by conditioning consent on the taxpayer's agreement to make correcting adjustments in his income tax payments. _The danger of distortion of income detrimental to governmental revenues exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one_. (Emphasis added.)

See, _Commissioner_ v. _O. Liquidating Corp_., 292 F. 2d 225, 230 (C.A. 3, 1961), cert. denied, 368 U.S. 898 (1961).

The essence of the taxpayer's change of accounting method in this case was a change from a reserve method, under which an estimate of the taxpayer's insurance expense was charged against income in the year when the related revenues were earned,

to an actual expenditures method, under which all expenditures were to be charged against income in the year paid. Under the taxpayer's old method of accounting, to the extent of the balance in the reserve at any time, deductions will have been taken for items reasonably anticipated, but not yet actually paid out, and, implicit in this method of accounting was the assumption that, when paid, these items would be charged to the reserve and would not result in any further deductions. When the taxpayer was required to change to the actual expenditures method, however, and solely as a result of that change, no further charges would ever be made to the reserve and all expenditures would be allowable as deductions when paid. Accordingly, unless an adjustment is now made under Section 481 for 1968, the opening balance in the reserve for insurance expense will never be taken into account, and, although already deducted, it will never reduce the taxpayer's allowable deductions in future years. This is precisely the sort of doubling up of deductions which Section 481 was intended to prevent. S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 307-309 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4947-4949).

CONCLUSION

For the reasons stated, the decision of the Tax Court should be reversed, and the case should be remanded for computation of the correct amount of the deficiency based on the inclusion of the opening balance in the taxpayer's reserve for insurance account in its gross income for the fiscal year ended June 30, 1968.

Respectfully submitted,

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MARCH, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 31st day of March, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * *

(e) Requirement Respecting Change of Accounting Method.--Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) [as amended by Sec. 29(a)(1), Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] General Rule.--In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.446-1 General rule for methods of accounting.

* * *

(e) Requirement respecting the adoption or change of accounting method.

* * *

(ii) (a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code. A change

in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

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§ 1.481-1 <u>Adjustments in general</u>.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of § 1.446-1. In computing taxable income for the taxable year of the change there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

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